



**Comptroller General
of the United States**

**United States Government Accountability Office
Washington, DC 20548**

December 14, 2004

The President
The President of the Senate
The Speaker of the House of Representatives

Our report on the U.S. government's consolidated financial statements for the fiscal years 2004 and 2003 is enclosed. As in the seven previous fiscal years, certain material weaknesses in internal control and in selected accounting and financial reporting practices resulted in conditions that continued to prevent us from being able to provide the Congress and American citizens an opinion as to whether the consolidated financial statements of the U.S. government are fairly stated in conformity with U.S. generally accepted accounting principles.

Proper accounting and financial reporting practices are essential in the public sector. The U.S. government is the largest, most diverse, most complex, and arguably the most important entity on earth today. Its services and programs—homeland security, national defense, Social Security, health care, mail delivery, and food inspection, to name just a few—directly affect the well-being of almost every American. Sound decisions on the current results and future direction of vital federal programs and policies are made more difficult without timely, reliable, and useful financial and performance information.

Until the problems discussed in our audit report are adequately addressed, they will continue to present a number of adverse implications for the federal government and the taxpayers, which are outlined in our report. At the same time, the need for timely, reliable, and useful financial and performance information is greater than ever. Our nation's large and growing long-term fiscal imbalance, which is driven largely by known demographic trends and rising health care costs, coupled with new homeland security and defense commitments and the recent downward trend in revenue as a share of gross domestic product, serves to sharpen the need to fundamentally review and re-examine the base of federal entitlement, discretionary, and other spending and tax policies. Clearly, tough choices will be required to address the resulting structural imbalance.

In March 2004, the Trustees of the Social Security and Medicare trust funds issued their 2004 annual reports on the current and projected status of these programs. Once again, the trustees' reports confirmed that both the Social Security and Medicare programs are

unsustainable in their present form. The trustees also noted that Medicare's financial difficulties are much more severe than those confronting Social Security. In addition, the new prescription drug benefit, which is one of the largest unfunded commitments ever undertaken by the federal government, has served to significantly increase the unfunded commitments associated with the Medicare program. Specifically, in their 2004 report, the trustees estimated the present value cost to the federal government of this new benefit over the next 75 years to be \$8.1 trillion as of January 1, 2004. The trustees reiterated the message contained in their previous reports that action to address the financial difficulties facing Social Security and Medicare should be taken in a timely manner and that the sooner these financial challenges are addressed, the more varied and less disruptive the solutions can be.

The federal government's gross debt¹ as of September 2004 was about \$7.4 trillion, or about \$25,000 for every man, woman, and child in the country. But that number excludes such items as the gap between promised and funded Social Security and Medicare benefits, veterans' health care, and a range of other unfunded commitments and contingencies that the federal government has pledged to support. If these items are factored in, the current dollar burden for every American rises to about \$145,000 per person, or about \$350,000 per full-time worker. GAO's fiscal policy simulations illustrate that the fiscal policies in place today—absent substantive entitlement reform or unprecedented changes in tax and/or spending policies—will result in large, escalating, and persistent deficits that are economically unsustainable over the long term. Without reform, known demographic trends, rising health care costs, and projected growth in federal spending for Social Security, Medicare, and Medicaid will result in massive fiscal pressures that, if not effectively addressed, could cripple the economy, threaten our national security, and adversely affect the quality of life of Americans in the future.

The President and the Congress face the challenge of sorting out the many claims on the federal budget without the budget enforcement mechanisms or fiscal benchmarks that guided the federal government through the years of deficit reduction into a brief period of federal surpluses. While a number of steps will be necessary to address this challenge, truth and transparency in federal government financial reporting and budgeting are essential elements of any attempt to address the nation's long-term fiscal challenges. The fiscal risks just mentioned can be managed only if they are properly accounted for and publicly disclosed, including the many existing commitments facing the government. In addition, new budget control mechanisms will be required, along with effective approaches to successfully engage in a fundamental review, reassessment, and reprioritization of the base of federal government programs and policies that I have mentioned previously. In this regard, we should not assume that all defense and homeland security expenditures are both necessary and prudent. Furthermore, the use of across-the-board adjustments to address the spending imbalance serves to avoid making the necessary difficult choices, is inequitable, and simply will not get the job done.

¹The federal government's gross debt consists of debt held by the public and intragovernmental debt holdings.

In identifying improved financial performance as one of its five governmentwide initiatives, the President's Management Agenda recognized that a clean (unqualified) financial audit opinion is a basic prescription for any well-managed organization. The Principals of the Joint Financial Management Improvement Program (JFMIP)² defined certain measures, in addition to receiving an unqualified financial statement opinion, for achieving financial management success. These additional measures include being able to routinely provide timely, accurate, and useful financial and performance information and having no material internal control weaknesses or material noncompliance with laws and regulations and the requirements of the Federal Financial Management Improvement Act of 1996.

For fiscal year 2004, the Office of Management and Budget (OMB) accelerated the financial statements reporting date for agencies to November 15, 2004, as compared with January 30, 2004, for fiscal year 2003. Twenty-two of 23 Chief Financial Officers (CFO) Act agencies were able to issue their fiscal year 2004 financial statements by the accelerated reporting date. As such, these results represent a significant improvement over fiscal year 2003 in the timeliness of CFO Act agencies' issuance of their financial statements.

For fiscal year 2004, 18 of 23 CFO Act agencies were able to attain unqualified audit opinions on their financial statements. A trend during fiscal year 2004 that merits concern and close scrutiny was the growing number of CFO Act agencies that restated certain of their financial statements for fiscal year 2003 to correct errors. At least 10³ of the 23 CFO Act agencies fell into this category in fiscal year 2004, as compared with at least 4 CFO Act agencies that had restatements in fiscal year 2003, covering their fiscal year 2002 financial statements. At least 2 CFO Act agencies had restatements in both years. Frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties.

With accelerated reporting, which we support in concept, it is even more imperative that federal agency management continue to work toward fully resolving the pervasive and generally long-standing material weaknesses that have been reported at the agency level for the past 9 fiscal years. Otherwise, federal agencies may risk incurring additional costs while at the same time sacrificing reliability to achieve accelerated reporting. In addition, continued leadership from OMB and Treasury will be important to resolve the issues that have served to prevent us from expressing an opinion on the consolidated financial

²JFMIP was a joint and cooperative undertaking of the Department of the Treasury, GAO, the Office of Management and Budget (OMB), and the Office of Personnel Management working in cooperation with each other and other federal agencies to improve financial management practices in the federal government. Leadership and program guidance were provided by the four Principals of the JFMIP—the Comptroller General of the United States, the Secretary of the Treasury, and the Directors of OMB and the Office of Personnel Management. Although JFMIP ceased to exist as a stand-alone organization as of December 1, 2004, the JFMIP Principals will continue to meet at their discretion.

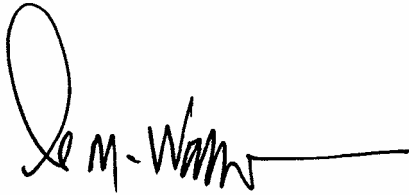
³Eight of these 10 agencies received an unqualified opinion on their originally issued fiscal year 2003 financial statements. Of these 8, the auditors for the Department of Justice withdrew the unqualified opinion that had been previously rendered on the department's fiscal year 2003 financial statements and issued a disclaimer of opinion on these restated financial statements, and the auditors for the Nuclear Regulatory Commission withdrew the unqualified opinion on the commission's fiscal year 2003 financial statements and issued a qualified opinion on these restated financial statements.

statements. Further, there will need to be ongoing and sustained top management attention to business systems transformation at the Department of Defense to address what are some of the most difficult financial management challenges in the federal government. These issues are discussed in detail in our auditor's report.

- - - - -

Once again, we appreciate the cooperation and assistance of Department of the Treasury and OMB officials, as well as the chief financial officers and inspectors general, in carrying out our statutory responsibility to report on the U.S. government's consolidated financial statements. We look forward to continuing to work with these officials and the Congress to achieve the goals and objectives of financial management reform.

Our report was prepared under the direction of Jeffrey C. Steinhoff, Managing Director, and Gary T. Engel, Director, Financial Management and Assurance. If you have any questions, please contact me on (202) 512-5500 or them on (202) 512-2600.

A handwritten signature in black ink, appearing to read "D. M. Walker", followed by a horizontal line.

David M. Walker
Comptroller General
of the United States



Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

The President
The President of the Senate
The Speaker of the House of Representatives

The Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget (OMB), is required annually to submit financial statements for the U.S. government to the President and the Congress. GAO is required to audit these statements.¹ This is our report on the accompanying U.S. government's consolidated financial statements for the fiscal years ended September 30, 2004 and 2003,² and our associated reports on internal control and compliance with laws and regulations.

The federal government is responsible for (1) preparing annual consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP); (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met,³ and (3) complying with applicable laws and regulations. Also, the 23 Chief Financial Officers (CFO) Act agencies⁴ are responsible for implementing and maintaining financial management systems that substantially comply with Federal Financial Management Improvement Act of 1996 (FFMIA)⁵ requirements. Our objective

¹The Government Management Reform Act of 1994 has required such reporting, covering the executive branch of government, beginning with financial statements prepared for fiscal year 1997. 31 U.S.C. 331 (e). The federal government has elected to include certain financial information on the legislative and judicial branches in the consolidated financial statements as well.

²The consolidated financial statements for the fiscal years ended September 30, 2004 and 2003, consist of the Statements of Operations and Changes in Net Position, Statements of Net Cost, Reconciliations of Net Operating Cost and Unified Budget Deficit, Statements of Changes in Cash Balance from Unified Budget and Other Activities, and Balance Sheets, including the related notes to these financial statements.

³31 U.S.C. 3512 (c), (d) (commonly referred to as FMFIA). This act requires agency heads to evaluate and report annually to the President on the adequacy of their internal control and accounting systems and on actions to correct significant problems.

⁴31 U.S.C. 901 (b). The Federal Emergency Management Agency (FEMA) was transferred to the new Department of Homeland Security (DHS) effective March 1, 2003. With this transfer, FEMA is no longer required to prepare and have audited stand-alone financial statements under the CFO Act, leaving 23 CFO Act agencies for fiscal year 2004. DHS, along with most other executive branch agencies, is required to prepare and have audited financial statements under the Accountability of Tax Dollars Act of 2002, Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002). The DHS Financial Accountability Act, Pub. L. No. 108-330, 118 Stat. 1275 (Oct. 16, 2004), added DHS to the list of CFO Act agencies and deleted FEMA, increasing the number of CFO Act agencies again to 24 for fiscal year 2005. With this designation, DHS is required to implement and maintain financial management systems that comply with FFMIA and its auditors will be required to report on DHS's financial management systems' compliance with FFMIA beginning with fiscal year 2005. Also beginning in fiscal year 2005, the law requires that the Secretary of DHS include in its performance and accountability report an assertion on the internal control over financial reporting. DHS's auditors will be required to opine on such internal control beginning in fiscal year 2006.

⁵31 U.S.C. 3512 note (Federal Financial Management Improvement).

was to audit the consolidated financial statements for the fiscal years ended September 30, 2004 and 2003. Appendix I discusses the scope and methodology of our work.

A significant number of material weaknesses⁶ related to financial systems, fundamental recordkeeping and financial reporting, and incomplete documentation continued to (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; (2) affect the federal government's ability to reliably measure the full cost as well as the financial and nonfinancial performance of certain programs; (3) impair the federal government's ability to adequately safeguard significant assets and properly record various transactions; and (4) prevent the federal government from having reliable financial information to operate in an economical, efficient, and effective manner. We found the following:

- Material deficiencies in financial reporting (which also represent material weaknesses) and other limitations on the scope of our work resulted in conditions that continued to prevent us from forming and expressing an opinion on the accompanying consolidated financial statements for the fiscal years ended September 30, 2004 and 2003.⁷
- The federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations as of September 30, 2004.
- Our work to determine compliance with selected provisions of applicable laws and regulations in fiscal year 2004 was limited by the material weaknesses discussed in this report.

DISCLAIMER OF OPINION ON THE CONSOLIDATED FINANCIAL STATEMENTS

Because of the federal government's inability to demonstrate the reliability of significant portions of the U.S. government's accompanying consolidated financial statements for fiscal years 2004 and 2003, principally resulting from the material deficiencies, and other limitations on the scope of our work, described in this report, we are unable to, and we do not, express an opinion on such financial statements.

As a result of the material deficiencies in the federal government's systems, recordkeeping, documentation, and financial reporting and scope limitations, readers are cautioned that amounts reported in the consolidated financial statements and related notes may not be reliable. These material deficiencies and scope limitations also affect the

⁶A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis.

⁷We previously reported that material deficiencies prevented us from expressing an opinion on the consolidated financial statements of the U.S. government for fiscal years 1997 through 2003.

reliability of certain information contained in the accompanying Management's Discussion and Analysis and other financial management information—including information used to manage the government day to day and budget information reported by federal agencies—that is taken from the same data sources as the consolidated financial statements.

We have not audited and do not express an opinion on the Management's Discussion and Analysis, Stewardship Information, Supplemental Information, or other information included in the accompanying fiscal year 2004 *Financial Report of the United States Government*.

As disclosed in Note 17 to the consolidated financial statements, the fiscal year 2003 financial statements, on which we disclaimed an opinion, were restated to reflect certain Department of Defense (DOD) prior-period adjustments. Also as disclosed in Note 17, the federal government changed its method of accounting for national defense property, plant, and equipment effective October 1, 2002, to conform to Statement of Federal Financial Accounting Standards No. 23, *Eliminating the Category National Defense Property, Plant, and Equipment*.

Significant Matters of Emphasis

Before discussing the additional limitations on the scope of our work and the material deficiencies we identified, two significant matters require emphasis—the nation's fiscal imbalance and restatements of certain agencies' prior-year audited financial statements.

The Nation's Fiscal Imbalance

While we are unable to express an opinion on the U.S. government's consolidated financial statements, several key items deserve emphasis in order to put the information contained in the financial statements and the Management's Discussion and Analysis section of the *Financial Report of the United States Government* into context. First, the federal government reported a \$412.3 billion unified budget deficit and a \$568 billion on-budget deficit in fiscal year 2004, representing approximately 3.6 percent and 4.9 percent of gross domestic product (GDP), respectively.⁸ Importantly, a significant majority of this deficit was unrelated to the conflicts in Iraq and Afghanistan and additional homeland security costs. Second, the U.S. government's reported liabilities and unfunded social insurance and other obligations grew by over \$13 trillion in fiscal year 2004, primarily due to enactment of the new Medicare prescription drug benefit, and now are over \$43 trillion, representing close to four times current GDP.⁹ In addition, while the size of the

⁸The transactions of the Postal Service and the Social Security trust funds are classified as off-budget. As such, their reported surpluses—\$4 billion for the Postal Service and \$151 billion for the Social Security trust funds—are excluded from the on-budget deficit but included in the unified budget deficit.

⁹These amounts use social insurance obligations computed on an open group basis.

nation's long-term fiscal imbalance grew significantly during the fiscal year, the retirement of the "baby boom" generation is closer to becoming a reality. Given these and other factors, it seems clear that the nation's current fiscal path is unsustainable and that tough choices by the President and the Congress will be necessary in order to address the nation's large and growing fiscal imbalance.

Potential Impact of Restatements

A trend during fiscal year 2004 that bears concern and close scrutiny is the growing number of CFO Act agencies that restated certain of their financial statements for fiscal year 2003 to correct errors. At least 10¹⁰ of the 23 CFO Act agencies fell into this category as compared with at least 4 CFO Act agencies that had restatements in fiscal year 2003 covering their fiscal year 2002 financial statements. At least 2 CFO Act agencies had restatements in both years. Frequent restatements to correct errors can undermine public trust and confidence in both the entity and all responsible parties. The material internal control weaknesses discussed in this report serve to increase the risk that additional errors may occur and not be identified on a timely basis by management or the auditors, resulting in further restatements. We plan to perform a more detailed review as to the nature and causes of the restatements during our audit of the fiscal year 2005 consolidated financial statements.

Limitations on the Scope of Our Work

For fiscal year 2004, there were additional limitations on the scope of our work that were similar to limitations we reported for fiscal year 2003. As agreed with OMB and the Department of the Treasury (Treasury), we accelerated the time frame to issue our report on the audit of the consolidated financial statements for fiscal year 2004 to meet the federal government's December 15, 2004, accelerated reporting date. We stressed to OMB, Treasury, and significant federal agencies' CFOs and the respective inspectors general the importance of receiving requested key documents and information and a complete draft of the consolidated financial statements by certain predetermined time frames to enable us to perform the necessary audit procedures to meet this accelerated reporting date. However, primarily due to incomplete and inaccurate submissions to Treasury by several federal agencies of certain key information used by Treasury to prepare the consolidated financial statements, along with some of the challenges and problems encountered with implementing a new compilation process and other weaknesses in financial statement preparation, as discussed below, Treasury's ability to timely provide us with complete and properly supported drafts of the consolidated financial statements was significantly impaired. As a result, we did not receive the U.S. government's consolidated financial statements in time to complete all of our planned

¹⁰Eight of these 10 agencies received an unqualified opinion on their originally issued fiscal year 2003 financial statements. Of these 8, the auditors for the Department of Justice withdrew the unqualified opinion that had been previously rendered on the department's fiscal year 2003 financial statements and issued a disclaimer of opinion on these restated financial statements, and the auditors for the Nuclear Regulatory Commission withdrew the unqualified opinion on the commission's fiscal year 2003 financial statements and issued a qualified opinion on these restated financial statements.

auditing procedures related to the compilation of these financial statements by the reporting date. In addition, certain audit documentation for several federal agencies were not made available to us in time to complete certain of our planned audit procedures in key areas, including planned audit procedures related to the Department of Health and Human Services (HHS).¹¹

We also continued to identify concerns with the adequacy of certain federal agencies' management and legal representations on which Treasury and OMB depend to provide their representations to us regarding the U.S. government's consolidated financial statements. Further, due to the lack of timely submission of HHS's legal representations to the Department of Justice, we did not receive the final legal representation letter for the consolidated financial statements as of the date of the completion of our fieldwork and as such could not complete our planned auditing procedures by the accelerated reporting date.

Material Deficiencies

The federal government did not maintain adequate systems or have sufficient, reliable evidence to support certain material information reported in the accompanying consolidated financial statements, as briefly described below. The largest and most challenging impediment to rendering any opinion on the U.S. government's consolidated financial statements continues to be serious financial management problems at DOD. These material deficiencies (which also represent material weaknesses), which generally have existed for years, contributed to our disclaimer of opinion and also constitute material weaknesses in internal control. Appendix II describes the material deficiencies in more detail and highlights the primary effects of these material weaknesses on the accompanying consolidated financial statements and on the management of federal government operations. These material deficiencies were the federal government's inability to

- satisfactorily determine that property, plant, and equipment and inventories and related property, primarily held by DOD, were properly reported in the consolidated financial statements;
- reasonably estimate or adequately support amounts reported for certain liabilities, such as environmental and disposal liabilities, or determine whether commitments and contingencies were complete and properly reported;
- support significant portions of the total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain agencies;

¹¹The auditor's report for HHS's financial statements for fiscal year 2004 was dated December 6, 2004.

- ensure that the federal government's consolidated financial statements were consistent with the underlying audited agency financial statements, balanced, and in conformity with GAAP;
- adequately account for and reconcile intragovernmental activity and balances between federal agencies; and
- resolve material differences that exist between the total net outlays reported in federal agencies' Statements of Budgetary Resources and the records used by Treasury to prepare the Statements of Changes in Cash Balance.

Due to the additional limitations on the scope of our work and the material deficiencies discussed above, there may also be additional issues that could affect the consolidated financial statements that have not been identified.

ADVERSE OPINION ON INTERNAL CONTROL

Because of the effects of the material weaknesses discussed in this report, in our opinion, the federal government did not maintain effective internal control as of September 30, 2004, to meet the following objectives: (1) transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements and stewardship information in conformity with GAAP, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition; and (2) transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and stewardship information. Consequently, the federal government's internal control did not provide reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis. Our adverse opinion on internal control over financial reporting and compliance is based upon the criteria established under FMFIA. Individual federal agency financial statement audit reports identify additional reportable conditions¹² in internal control, some of which were reported by agency auditors as being material weaknesses at the individual agency level. These matters do not represent material weaknesses at the governmentwide level. Also, due to the issues noted throughout this report, additional material weaknesses may exist that have not been reported.

In addition to the material weaknesses that represented material deficiencies, which were discussed above, we found the following four other material weaknesses in internal control as of September 30, 2004. These weaknesses are discussed in more detail in appendix III, including the primary effects of the material weaknesses on the accompanying consolidated financial statements and on the management of federal

¹²Reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal control that could adversely affect the federal government's ability to meet the internal control objectives described in this report.

government operations. These material weaknesses were the federal government's inability to

- implement effective processes and procedures for properly estimating the cost of certain lending programs, related loan guarantee liabilities, and value of direct loans;
- determine the extent to which improper payments exist;
- identify and resolve information security control weaknesses and manage information security risks on an ongoing basis; and
- effectively manage its tax collection activities.

COMPLIANCE WITH APPLICABLE LAWS AND REGULATIONS

Our work to determine compliance with selected provisions of applicable laws and regulations related to financial reporting was limited by the material weaknesses and scope limitations discussed above. U.S. generally accepted government auditing standards and OMB guidance require auditors to report on the agency's compliance with laws and regulations. Certain individual agency audit reports contain instances of noncompliance. None of these instances were material to the accompanying consolidated financial statements.

We caution that other noncompliance may have occurred and not been detected. Further, the results of our limited procedures may not be sufficient for other purposes. Our objective was not to, and we do not, express an opinion on compliance with applicable laws and regulations.

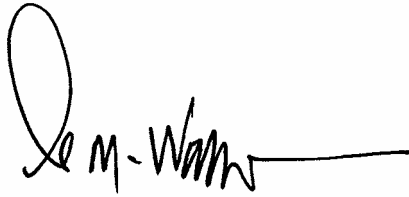
AGENCY FINANCIAL MANAGEMENT SYSTEMS

To achieve the financial management improvements envisioned by the CFO Act, FFMIA, and, more recently, the President's Management Agenda, federal agencies need to modernize their financial management systems to generate reliable, useful, and timely financial and performance information throughout the year as well as at year-end. As discussed throughout this report, serious financial management weaknesses have contributed significantly to our inability to determine the reliability of the consolidated financial statements. FFMIA requires auditors, as part of the CFO Act agencies' financial statement audits, to report whether agencies' financial management systems substantially comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the federal government's Standard General Ledger at the transaction level. For fiscal year 2004, auditors for 16 of 23 CFO Act agencies reported that the agencies financial management systems did not comply substantially with one or more of these three FFMIA requirements. A 24th agency, DHS, was not subject to the requirements of the CFO Act for fiscal year 2004, and, consequently, was

not required to comply with FFMIA. Accordingly, DHS's auditor did not report on DHS's compliance with FFMIA for fiscal year 2004. However, the auditor identified and reported deficiencies that related to the requirements of FFMIA noted above.

- - - - -

We provided a draft of this report to Treasury and OMB officials, who provided technical comments, which have been incorporated as appropriate. Treasury and OMB officials expressed their continuing commitment to address problems this report outlines.

A handwritten signature in black ink, appearing to read "D. M. Walker", followed by a horizontal line.

David M. Walker
Comptroller General
of the United States

December 6, 2004

APPENDIX I

OBJECTIVES, SCOPE, AND METHODOLOGY

The Government Management Reform Act of 1994 expanded the requirements of the Chief Financial Officers (CFO) Act by making the inspectors general of 24 major federal agencies¹³ responsible for annual audits of agencywide financial statements prepared by these agencies and GAO responsible for the audit of the U.S. government's consolidated financial statements.¹⁴ The Accountability of Tax Dollars (ATD) Act of 2002¹⁵ requires most other executive branch agencies to prepare and have audited annual financial statements. The Office of Management and Budget and the Department of the Treasury (Treasury) have identified 35 agencies¹⁶ that are significant to the U.S. government's consolidated financial statements. Our work was performed in coordination and cooperation with the inspectors general and independent public accountants to achieve our joint audit objectives. Our audit approach focused primarily on determining the current status of the material deficiencies and the other material weaknesses affecting internal control that we had previously reported in our report on the consolidated financial statements for fiscal year 2003.¹⁷ Our work included separately auditing the following significant federal agency components:

- We audited and expressed an unqualified opinion on the Internal Revenue Service's (IRS) fiscal years 2004 and 2003 financial statements, which included approximately \$2 trillion of tax revenue for both fiscal years; \$278 billion and \$300 billion of tax refunds for fiscal years 2004 and 2003, respectively; and \$20 billion of net federal taxes receivable each year.¹⁸ In fiscal year 2004, we continued to report numerous material internal control weaknesses, which resulted in ineffective internal control. Our tests of compliance with selected provisions of laws and regulations disclosed two areas of noncompliance. We also found that IRS's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996.
- We audited and expressed an unqualified opinion on the Schedules of Federal Debt managed by Treasury's Bureau of the Public Debt (BPD) for the fiscal years ended September 30, 2004 and 2003.¹⁹ The schedules reported for these 2 fiscal years (1) approximately \$4.3 trillion (2004) and \$3.9 trillion (2003) of federal debt held by the

¹³31 U.S.C. 901(b), 3521(e), but see footnote 4.

¹⁴The 1994 act authorized the Office of Management and Budget to designate agency components that also would receive a financial statement audit. 31 U.S.C. 3515(c).

¹⁵Pub. L. No. 107-289, 116 Stat. 2049 (Nov. 7, 2002).

¹⁶See *Treasury Financial Manual*, volume I, part 2, chapter 4700, for a listing of the 35 agencies.

¹⁷For our report on the U.S. government's consolidated financial statements for fiscal year 2003, see U.S. Department of the Treasury, *Financial Report of the United States Government* (Washington, D.C. February 2004), pp. 37-52, which can be found on GAO's Internet site at www.gao.gov.

¹⁸GAO, *Financial Audit: IRS's Fiscal Years 2004 and 2003 Financial Statements*, GAO-05-103 (Washington, D.C.: Nov. 10, 2004).

¹⁹GAO, *Financial Audit: Bureau of the Public Debt's Fiscal Years 2004 and 2003 Schedules of Federal Debt*, GAO-05-116 (Washington, D.C.: Nov. 5, 2004).

public;²⁰ (2) about \$3.1 trillion (2004) and \$2.9 trillion (2003) of intragovernmental debt holdings;²¹ and (3) nearly \$158 billion (2004) and \$157 billion (2003) of interest on federal debt held by the public.²² We reported that as of September 30, 2004, BPD had effective internal control over financial reporting and compliance with applicable laws and regulations relevant to the Schedule of Federal Debt. Further, we reported that there was no reportable noncompliance in fiscal year 2004 with a law we tested.

- We audited and expressed unqualified opinions on the December 31, 2003 and 2002, financial statements of the funds administered by the Federal Deposit Insurance Corporation (FDIC), including the Bank Insurance Fund, the Savings Association Insurance Fund, and the FSLIC Resolution Fund.²³ We reported that as of December 31, 2003, FDIC had effective internal control over financial reporting and compliance with laws and regulations. In addition, we performed certain procedures and tests of internal control over certain material balances of the funds administered by FDIC as of September 30, 2004.

We considered the CFO Act agencies' and certain other federal agencies' fiscal years 2004 and 2003 financial statements and the related auditors' reports prepared by the inspectors general or contracted independent public accountants. Financial statements and audit reports for these agencies provide information about the operations of each of these entities. We did not audit, and we do not express an opinion on, any of these individual federal agency financial statements.

We considered the Department of Defense's (DOD) assertion provided to the DOD Inspector General that DOD management prepared and submitted pursuant to the provisions of the National Defense Authorization Act for Fiscal Year 2002.²⁴ In accordance with section 1008 of this act, DOD reported that its fiscal year 2004 financial statements were not completely reliable. DOD cited deficiencies in several areas affecting its financial statements, including among others (1) property, plant, and equipment; (2) inventory and operating material and supplies; (3) environmental liabilities; (4) intragovernmental eliminations and related accounting adjustments; and (5) disbursement activity.

We performed sufficient audit work to provide this report on the consolidated financial statements, internal control, and the results of our assessment of compliance with applicable laws and regulations. We considered the limitations on the scope of our work in forming our conclusions. Our work was performed in accordance with U.S. generally accepted government auditing standards.

²⁰The public holding federal debt is comprised of individuals, corporations, state and local governments, the Federal Reserve Banks, and foreign governments and central banks.

²¹Intragovernmental debt holdings represent federal debt issued by Treasury and held by certain federal government accounts such as the Social Security and Medicare trust funds.

²²On November 19, 2004, legislation was enacted to raise the statutory debt limit by \$800 billion to \$8.184 trillion. Pub. L. No. 108-415, 118 Stat. 2337 (Nov. 19, 2004).

²³GAO, *Financial Audit: Federal Deposit Insurance Corporation Funds' 2003 and 2002 Financial Statements*, GAO-04-429 (Washington, D.C.: Feb. 13, 2004).

²⁴Pub. L. No. 107-107, §1008, 115 Stat. 1012, 1204 (Dec. 28, 2001).

APPENDIX II

Material Deficiencies

The continuing material deficiencies discussed below contributed to our disclaimer on the federal government's consolidated financial statements. The federal government did not maintain adequate systems or have sufficient, reliable evidence to support information reported in the accompanying consolidated financial statements, as described below.

Property, Plant, and Equipment and Inventories and Related Property

The federal government could not satisfactorily determine that property, plant, and equipment (PP&E) and inventories and related property were properly reported in the consolidated financial statements. Most of the PP&E and inventories and related property are the responsibility of the Department of Defense (DOD). As in past years, DOD did not maintain adequate systems or have sufficient records to provide reliable information on these assets. Other agencies, most notably the National Aeronautics and Space Administration, reported continued weaknesses in internal control procedures and processes related to PP&E.

Without reliable asset information, the federal government does not fully know the assets it owns and their location and condition and cannot effectively (1) safeguard assets from physical deterioration, theft, or loss; (2) account for acquisitions and disposals of such assets; (3) ensure that the assets are available for use when needed; (4) prevent unnecessary storage and maintenance costs or purchase of assets already on hand; and (5) determine the full costs of programs that use these assets.

Liabilities and Commitments and Contingencies

The federal government could not reasonably estimate or adequately support amounts reported for certain liabilities. For example, DOD was not able to estimate with assurance key components of its environmental and disposal liabilities. In addition, DOD could not support a significant amount of its estimated military postretirement health benefits liabilities included in federal employee and veteran benefits payable. These unsupported amounts related to the cost of direct health care provided by DOD-managed military treatment facilities. Further, the federal government could not determine whether commitments and contingencies, including those related to treaties and other international agreements entered into to further the U.S. government's interests, were complete and properly reported.

Problems in accounting for liabilities affect the determination of the full cost of the federal government's current operations and the extent of its liabilities. Also, improperly stated environmental and disposal liabilities and weak internal control supporting the process for their estimation affect the federal government's ability to determine priorities

for cleanup and disposal activities and to appropriately consider future budgetary resources needed to carry out these activities. In addition, when disclosures of commitments and contingencies are incomplete or incorrect, reliable information is not available about the extent of the federal government's obligations.

Cost of Government Operations and Disbursement Activity

The previously discussed material deficiencies in reporting assets and liabilities, material deficiencies in financial statement preparation, as discussed below, and the lack of adequate disbursement reconciliations at certain federal agencies affect reported net costs. As a result, the federal government was unable to support significant portions of the total net cost of operations, most notably related to DOD.

With respect to disbursements, DOD and certain other federal agencies reported continued weaknesses in reconciling disbursement activity. For fiscal years 2004 and 2003, there was unreconciled disbursement activity, including unreconciled differences between federal agencies' and the Department of the Treasury's (Treasury) records of disbursements and unsupported federal agency adjustments, totaling billions of dollars, which could also affect the balance sheet.

Unreliable cost information affects the federal government's ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required. Improperly recorded disbursements could result in misstatements in the financial statements and in certain data provided by federal agencies for inclusion in the President's budget concerning obligations and outlays.

Preparation of Consolidated Financial Statements

During fiscal year 2004, Treasury made progress in laying the foundation to address certain long-standing material deficiencies in preparing the consolidated financial statements. Foremost is the ongoing development of a new system, the Governmentwide Financial Reporting System (GFRS), to collect agency financial statement information directly from federal agencies' audited financial statements rather than using federal agencies' Standard General Ledger data as Treasury had done in previous years to compile the consolidated financial statements. The goal of the new system is to be able to directly link information from federal agencies' audited financial statements to amounts reported in the consolidated financial statements, a concept that we strongly support. Once Treasury is able to achieve this, it would eliminate a major impediment to our being able to audit the consolidated financial statements.

For the fiscal year 2004 reporting process, Treasury's GFRS was able to capture certain agency financial information from agencies' audited financial statements, which is an important first step. The automated system, though, was not yet at the stage of development that it could be used to compile the consolidated financial statements from

the information that was captured. Therefore, for fiscal year 2004, Treasury had to rely primarily on Excel spreadsheets and extensive manual procedures to prepare the consolidated financial statements. As discussed in our scope limitation section of this report, the federal government could not produce the fiscal year 2004 consolidated financial statements in time for us to complete all of our planned auditing procedures. In addition, for fiscal year 2004, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, balanced, and in conformity with U.S. generally accepted accounting principles (GAAP). Specifically, during our fiscal year 2004 audit, we found the following:²⁵

- Treasury's process for compiling the consolidated financial statements did not ensure that the information in these statements was fully consistent with the underlying information in federal agencies' audited financial statements and other financial data.
- Treasury's ability to timely prepare a complete set of consolidated financial statements was greatly impaired because in some cases the financial information provided by federal agencies to Treasury did not agree to the agencies' audited financial statements, causing Treasury to have to resort to last-minute, alternative methods to gather the needed information. These problems were compounded by Treasury's reliance on internal controls that were dependent on procedures that would attempt to identify any errors after they were made by an agency (detective controls) rather than implementation of internal controls that may have prevented or minimized the errors from occurring (preventive controls).
- Other internal control weaknesses existed in Treasury's process for preparing the consolidated financial statements, involving a lack of (1) segregation of duties, (2) appropriate documentation of certain policies and procedures for preparing the consolidated financial statements, (3) adequate support for adjustments made to the consolidated financial statements, and (4) required management reviews.
- Information system weaknesses existed within the segments of GFRS that were used during the fiscal year 2004 reporting process. We found that inappropriate access to GFRS was granted to certain Treasury personnel and that the GFRS database was not configured to prevent the alteration of data submitted by federal agencies and was used for both production and testing during the fiscal year 2004 reporting process.
- Treasury did not have the infrastructure to address the magnitude of the fiscal year 2004 financial reporting challenges it was faced with, such as an incomplete financial reporting system, compressed time frames for compiling the financial information,

²⁵Most of the issues we identified in fiscal year 2004 existed in fiscal year 2003, and some have existed for a number of years. In September 2004, we reported in greater detail on the issues we identified, in GAO, *Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Further Improvement*, GAO-04-866 (Washington, D.C.: Sept. 10, 2004). This report includes about 140 recommendations to the federal government.

and inaccurate and incomplete information provided by certain federal agencies. We found that personnel at Treasury's Financial Management Service had excessive workloads that required an extraordinary amount of effort and dedication to compile the consolidated financial statements; however, there were not enough personnel with specialized financial reporting experience to ensure accurate and reliable financial reporting by the accelerated reporting date. Nevertheless, a foundation for the future was put into place and a number of lessons were learned.

- To make the fiscal years 2004 and 2003 consolidated financial statements balance, Treasury recorded a net \$3.4 billion increase and a net \$24.5 billion decrease, respectively, to net operating cost on the Statements of Operations and Changes in Net Position, which it labeled "Unreconciled Transactions Affecting the Change in Net Position."²⁶ An additional net \$1.2 billion and \$11.3 billion of unreconciled transactions were recorded in the Statement of Net Cost for fiscal years 2004 and 2003, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.
- Treasury eliminated many intragovernmental activity and balances through accounting entries for fiscal year 2004 rather than "dropping" or "offsetting" the amounts as it has done in the past, which is a positive step. However, as discussed below, amounts reported for federal agency trading partners²⁷ for certain intragovernmental accounts were significantly out of balance, resulting in the need for unsupported intragovernmental elimination entries in order to force the Statement of Operations and Changes in Net Position into balance. Treasury's ability to eliminate certain intragovernmental activity and balances continues to be impaired by the federal agencies' problems in handling their intragovernmental transactions, which are noted below. In addition, significant differences in other intragovernmental accounts, primarily related to appropriations, have not been reconciled and still remain unresolved. Therefore, the federal government continues to be unable to determine the impact of unreconciled intragovernmental activity and balances to the consolidated financial statements.
- The federal government did not have an adequate process to identify and report items needed to reconcile the operating results, which for fiscal year 2004 showed a net operating cost of \$615.6 billion, to the budget results, which for the same period showed a unified budget deficit of \$412.3 billion. In addition, a net \$23.2 billion "net amount of all other differences" was needed to force this statement into balance.

²⁶Although Treasury was unable to determine how much of the unreconciled transactions, if any, relate to operations, it reported unreconciled transactions as a component of net operating cost in the accompanying consolidated financial statements.

²⁷Trading partners are U.S. government agencies, departments, or other components included in the consolidated financial statements that do business with each other.

- The consolidated financial statements include certain financial information for the executive, legislative, and judicial branches, to the extent that federal agencies within those branches have provided Treasury such information. However, there are undetermined amounts of assets, liabilities, costs, and revenues that are not included, and the federal government did not provide evidence or disclose in the consolidated financial statements that such excluded financial information was immaterial.
- Treasury did not have an adequate process to ensure that the financial statements, related notes, Stewardship Information, and Supplemental Information are presented in conformity with GAAP. For example, we found that certain financial information required by GAAP was not disclosed in the consolidated financial statements. Treasury did not provide us with documentation of its rationale for excluding this information. As a result of this and certain of the material deficiencies noted above, we were unable to determine if the missing information was material to the consolidated financial statements. In an effort to begin addressing this issue, we found that Treasury collected certain additional financial information required by GAAP in its new process for fiscal year 2004. However, due to the compressed time frames to compile the consolidated financial statements and because GFRS is still being developed, Treasury plans to analyze this information in fiscal year 2005 and determine how or whether to disclose this information in future years' consolidated financial statements.

Accounting for and Reconciliation of Intragovernmental Activity and Balances

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. The Office of Management and Budget (OMB) and Treasury require the chief financial officers (CFO) of 35 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. In addition, these agencies are required to report to Treasury, the agency's inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of the fiscal year.

A substantial number of the agencies did not fully perform the required reconciliations for fiscal years 2004 and 2003. For fiscal year 2004, based on trading partner information provided in GFRS, Treasury produced a "Material Difference Report" for each agency showing amounts for certain intragovernmental activity and balances that significantly differed from those of its corresponding trading partners. After analysis of the material differences, a significant number of CFOs cited differing accounting methodologies, accounting errors, and timing differences for their material differences with their trading partners. Many CFOs simply indicated that they were unable to explain the differences with their trading partners. For both fiscal years 2004 and 2003, amounts reported by federal agency trading partners for certain intragovernmental accounts were significantly out of balance. As a result, the federal government's ability to determine the impact of these differences on the amounts reported in the consolidated financial statements is

impaired. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a commitment by federal agencies and strong leadership and oversight by OMB.

Net Outlays—A Component of the Budget Deficit

OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, states that outlays in federal agencies' Statement of Budgetary Resources (SBR) should agree with the net outlays reported in the budget of the U.S. government. In addition, Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, requires explanation of any material differences between the information required to be disclosed (including net outlays) in the financial statements and the amounts described as "actual" in the budget of the U.S. government.

The federal government reported in the Statement of Changes in Cash Balance from Unified Budget and Other Activities (Statement of Changes in Cash Balance) a budget deficit for fiscal year 2004 of \$412.3 billion. The budget deficit is calculated by subtracting actual budget outlays from actual budget receipts.²⁸ In previous years, the Statement of Changes in Cash Balance reported actual budget outlays and actual budget receipts; however, for fiscal year 2004, the federal government chose not to disclose budget outlays and budget receipts in this financial statement and only included the budget deficit. As we reported for fiscal year 2003, we found \$140 billion in differences between the total net outlays reported in selected federal agencies' audited SBRs and Treasury's central accounting records, which it uses to prepare the Statement of Changes in Cash Balance. Treasury again chose for fiscal year 2004 to use its central accounting records to prepare the Statement of Changes in Cash Balance without a process for identifying and resolving the differences between its central accounting records and net outlay amounts reported in the agencies' audited SBRs. For fiscal year 2004, while Treasury no longer disclosed this information in the Statement of Changes in Cash Balance, we again found material differences between the total net outlays reported in certain federal agencies' audited SBRs and the records Treasury used to prepare the Statement of Changes in Cash Balance totaling about \$69 billion. In addition, we also noted reported internal control weaknesses regarding certain agencies' SBRs.

OMB's efforts in working with the agencies resulted in some notable improvements in reducing the approximately \$140 billion of differences that we reported in fiscal year 2003 between the total net outlays reported in the federal agencies' SBRs and the Statement of Changes in Cash Balance. As we reported, two agencies, Treasury and the Department of Health and Human Services (HHS), accounted for about 83 percent of these differences. We found that the major cause of the differences for the two agencies

²⁸Receipts and net outlays (unified budget amounts) are also reported in governmentwide reports—specifically, in the President's Budget (annually); Treasury's Final Monthly Treasury Statement, as part of leading economic indicators on federal finances (quarterly); and Treasury's Annual Combined Statement of Receipts, Outlays, and Balances of the United States Government.

for fiscal year 2003 was the treatment of offsetting receipts.²⁹ Some offsetting receipts for these two agencies had not been included in the agencies' SBRs, which would have reduced the agencies' net outlays and made the amounts more consistent with Treasury's records used to prepare the Statement of Changes in Cash Balance. In fiscal year 2004, a major component of HHS restated its fiscal year 2003 net outlays in its SBR, and Treasury obtained a waiver from OMB exempting it from reporting certain offsetting receipts in its SBR totaling about \$16.9 billion until further research is performed. However, about \$75 billion of differences we found for fiscal year 2003 still remained unreconciled as of September 30, 2004.

Until the material differences between the total net outlays reported in the federal agencies' SBRs and the records used to prepare the Statement of Changes in Cash Balance are timely reconciled, the effect of these differences on the U.S. government's consolidated financial statements will be unknown.

²⁹Offsetting receipts are collections that are credited to general fund, special fund, or trust fund receipt accounts and that offset gross outlays at the agency or governmentwide level.

APPENDIX III

Other Material Weaknesses

The federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations as of September 30, 2004. In addition to the material deficiencies discussed in appendix II, we found the following four other material weaknesses in internal control.

Loans Receivable and Loan Guarantee Liabilities

Federal agencies continue to have material weaknesses and reportable conditions related to their lending activities. In fiscal year 2004, significant deficiencies in the processes and procedures used to estimate the costs of certain lending programs and value of loans receivable increased. While the Small Business Administration (SBA) made noteworthy progress to improve its cost estimation processes, additional improvements are still needed at SBA to fully resolve the deficiencies in the area so that reasonable estimates can be produced and audited in a timely manner. Further, this year at the Department of Housing and Urban Development (HUD), a new material weakness was reported. HUD lacked adequate management reviews of underlying data and cost estimation methodologies that resulted in material errors being undetected, and significant adjustments were needed. These material weaknesses at SBA and HUD, plus deficiencies at the Department of Agriculture and the Department of Education relating to the processes and procedures for estimating credit program costs, continue to adversely affect the federal government's ability to support annual budget requests for these programs, make future budgetary decisions, manage program costs, and measure the performance of lending activities. Further, these weaknesses and the complexities associated with estimating the costs of lending activities greatly increase the risk that significant errors in agency and governmentwide financial statements could occur and go undetected.

Improper Payments

Across the federal government, improper payments occur in a variety of programs and activities, including those related to health care, contract management, federal financial assistance, and tax refunds.³⁰ Many improper payments occur in federal programs that are administered by entities other than the federal government, such as states and municipalities. Generally, improper payments result from a lack of or an inadequate system of internal control, but some result from program design issues. Federal agencies' estimates of improper payments based on available information for fiscal year 2004 exceeded \$45 billion. This estimate could increase significantly over the next several years as agencies become more effective at estimating and reporting improper payment

³⁰Improper payments include inadvertent errors, such as duplicate payments and miscalculations, payments for unsupported or inadequately supported claims, payments for services not rendered, payments to ineligible beneficiaries, and payments resulting from fraud and abuse by program participants and/or federal employees.

amounts for programs and activities that are susceptible to significant improper payments.³¹

Fiscal year 2004 represents the first full year that federal agencies were required to include the reports required by the Improper Payments Information Act of 2002 (IPIA)³² in their Performance and Accountability Reports (PAR). IPIA raised improper payments to a new level of importance by requiring federal agencies to annually review all programs and activities and identify those that may be susceptible to significant improper payments. Federal agencies are to then estimate the annual amount of improper payments for those programs and activities identified as susceptible to significant improper payments. The law further requires federal agencies to report to the Congress the improper payment estimates and information on the actions the agency is taking to reduce the improper payments. The Office of Management and Budget (OMB) implementation guidance required that estimates and, if applicable, the corrective action report, be included in federal agencies' PARs beginning with fiscal year 2004.³³

The OMB guidance also required 44 programs of 14 CFO Act agencies to report improper payment information in their fiscal year 2003 PARs. Last year, we reported that those 14 CFO Act agencies reported the required improper payment amounts for 29 of the 44 programs,³⁴ suggesting that despite the enhanced emphasis on improper payments and legislative reporting requirements, those agencies appeared to be struggling with estimating improper payment amounts for about one-third of their programs.

Our preliminary reviews of 29 federal agencies' fiscal year 2004 PARs further suggest that a number of agencies were not well positioned to meet the reporting requirements of IPIA. For example, while most agencies acknowledged the IPIA reporting requirements in their PARs, 8 of the 44 programs with previous reporting requirements as noted above indicated that they would be able to estimate and report on improper payments sometime within the next 4 years but could not do so now. Another 5 programs in 2 agencies with previous reporting requirements determined that improper payment amounts were insignificant for their programs. Further, 4 additional programs in 4 agencies with prior reporting requirements did not estimate improper payment amounts for their programs and were silent as to whether they would report estimates in future reports. Therefore, 32 of the 44 programs with previous reporting requirements reported estimates or reported that their improper payment amounts were insignificant in their fiscal year 2004 PARs.

Until all agencies develop and implement a systematic measurement of the extent of improper payments, the federal government cannot determine (1) the extent to which

³¹OMB defines the term "significant improper payments" as "annual erroneous payments in the program exceeding both 2.5 percent of program payments and \$10 million."

³²Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002).

³³OMB Memorandum M-03-13, *Improper Payments Information Act of 2002 (Public Law 107-300)* (Washington, D.C.: May 21, 2003).

³⁴GAO, *Financial Management: Fiscal Year 2003 Performance and Accountability Reports Provide Limited Information on Governmentwide Improper Payments*, GAO-04-631T (Washington, D.C.: Apr. 15, 2004).

improper payments exist, (2) mitigation strategies and the appropriate amount of investments to reduce them, and (3) the success of efforts implemented to reduce improper payments.

Information Security

Although progress has been made, serious and widespread information security control weaknesses continue to place federal assets at risk of inadvertent or deliberate misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. GAO has reported information security as a high-risk area across government since February 1997. Such information security control weaknesses could result in compromising the reliability and availability of data that are recorded in or transmitted by federal financial management systems. A primary reason for these weaknesses is that federal agencies have not yet fully institutionalized comprehensive security management programs, which are critical to identifying information security control weaknesses, resolving information security problems, and managing information security risks on an ongoing basis. The Congress has shown continuing interest in addressing these risks, as evidenced by hearings on information security and enactment of the Federal Information Security Management Act of 2002³⁵ and the Cyber Security Research and Development Act.³⁶ In addition, the administration has taken important actions to improve information security, such as integrating information security into the Executive Branch Management Scorecard.³⁷

Tax Collection Activities

Material internal control weaknesses and systems deficiencies continue to affect the federal government's ability to effectively manage its tax collection activities,³⁸ an issue that has been reported in our financial statement audit reports for the past 7 years. Due to errors and delays in recording activity in taxpayer accounts, taxpayers were not always credited for payments made on their taxes owed, which could result in undue taxpayer burden. In addition, the federal government did not always follow up on potential unreported or underreported taxes and did not always pursue collection efforts against taxpayers owing taxes to the federal government.

Weaknesses in controls over tax collection activities continue to affect the federal government's ability to efficiently and effectively account for and collect revenue. Additionally, weaknesses in financial reporting of revenues affect the federal government's ability to make informed decisions about collection efforts. As a result, the

³⁵Title III of the E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2899, 2946 (Dec. 17, 2002).

³⁶Pub. L. No. 107-305, 116 Stat. 2367 (Nov. 27, 2002).

³⁷The Executive Branch Management Scorecard highlights agencies' progress in achieving management and performance improvements embodied in the President's Management Agenda.

³⁸GAO, *Financial Audit: IRS's Fiscal Years 2004 and 2003 Financial Statements*, GAO-05-103 (Washington, D.C.: Nov. 10, 2004).

federal government is vulnerable to loss of tax revenue and exposed to potentially billions of dollars in losses due to inappropriate refund disbursements.

(198306)

This page is intentionally blank.